

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

76-7243

IN THE
United States Court of Appeals
For The Second Circuit

No. 76-7243

AUBREY B. LANK,
As Receiver of
PICKARD & COMPANY, INCORPORATED,
Plaintiff-Appellee,

—against—

THE NEW YORK STOCK EXCHANGE,
Defendant-Appellant.

*On Appeal from the United States District Court
For the Southern District of New York*

REPLY BRIEF FOR DEFENDANT-APPELLANT

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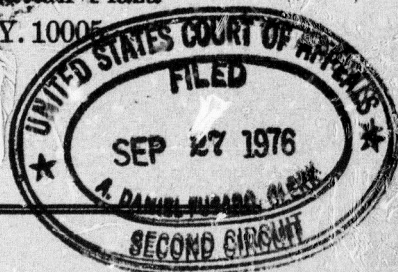


TABLE OF CONTENTS

	<u>PAGE</u>
PRELIMINARY STATEMENT -----	1
ARGUMENT -----	2
Point I —Lank Lacks Standing Because Pickard Lacks Standing -----	2
A. Lank's standing under Delaware law --	3
B. Pickard lacks standing -----	4
Point II —The Receiver's Claim Under Section 6 is Barred by the Statute of Limitations of CPLR § 214(2) -----	10
Point III—Dismissal of the Complaint is Appro- priate -----	15
CONCLUSION -----	16

TABLE OF AUTHORITIES

	<u>PAGE</u>
Cases:	
<i>Baird v. Franklin</i> , 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944) -----	6, 13
<i>Birnbaum v. Newport Steel Corp.</i> , 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 1356 (1952) -----	8
<i>Blue Chip Stamps v. Manor Drug Stores</i> , 421 U.S. 723 (1975) -----	3, 8, 9
<i>Bovay v. H. M. Byllesby & Co.</i> , 26 Del. Ch. 69, 22 A.2d 138 (1941) -----	4
<i>Bright v. Philadelphia-Baltimore-Washington Stock Exchange</i> , 327 F.Supp. 495 (E.D. Pa. 1971) -----	10
<i>Carr v. New York Stock Exchange</i> , 414 F.Supp. 1292 (N.D. Cal. 1976) -----	11
<i>Cort v. Ash</i> , 422 U.S. 66 (1975) -----	3, 5, 6, 9
<i>Dann v. Studebaker-Packard Corp.</i> , 288 F.2d 201 (6th Cir. 1961) -----	4
<i>Ernst & Ernst v. Hochfelder</i> , 423 U.S. 816 (1976) --	3, 9
<i>First National Bank of Cincinnati v. Pepper</i> , 454 F.2d 626 (2d Cir. 1972) -----	15
<i>Fischer v. New York Stock Exchange</i> , 408 F. Supp. 745 (S.D.N.Y. 1976) -----	14
<i>General Time Corp. v. American Investors Fund, Inc.</i> , 283 F.Supp. 400 (S.D.N.Y. 1968) -----	4
<i>Greater Iowa Corp. v. McLendon</i> , 378 F.2d 783 (8th Cir. 1967) -----	4-5
<i>Herpich v. Wallace</i> , 403 F.2d 792 (5th Cir. 1970) ---	4
<i>Hughes v. Dempsey-Tegeler & Co.</i> , [1973 Transfer Binder] CCH Fed.Sec.L.Rep. ¶94,133 (C.D. Cal. 1973), aff'd, 534 F.2d 156 (9th Cir. 1976) -----	3, 11, 14
<i>J.I. Case Co. v. Borak</i> , 377 U.S. 426 (1964) -----	4, 8

	<u>PAGE</u>
Cases:	
<i>Keedy v. Sterling Electrical Appliance Co.</i> , 13 Del. Ch. 66, 115 A. 359 (1921) -----	4
<i>Krasnow v. Kern Securities Corp.</i> , 175 N.Y.L.J., May 17, 1976, p. 8, col. 6 (Sup. Ct. N.Y.Co.) -----	12
<i>Lansing v. New York Stock Exchange</i> , 68 Civ. 2872 (S.D.N.Y. 1973), <i>aff'd</i> , 490 F.2d 1406 (2d Cir.), <i>cert. denied</i> , 417 U.S. 912 (1974) -----	2, 14
<i>Marbury Management Inc. v. Kohn, Wood, Walker & Co.</i> , 373 F.Supp. 140 (S.D.N.Y. 1974) -----	14
<i>Morganbesser v. New York Stock Exchange</i> , [1971-72 Transfer Binder] CCH Fed.Sec.L.Rep. ¶93,210 (Sup.Ct. Nassau Co. 1971) -----	12
<i>New York Stock Exchange, Inc. v. Goodbody & Co.</i> , 42 A.D.2d 556, 345 N.Y.S.2d 58 (1st Dept. 1973) --	12
<i>New York Stock Exchange, Inc. v. Pickard & Co.</i> , 282 A.2d 651 (Del. Ch. 1971) -----	12
<i>New York Stock Exchange, Inc. v. Sloan</i> , 394 F.Supp. 1303 (S.D.N.Y. 1975) -----	9
<i>Raldiris v. Simmons</i> , 242 App. Div. 603, 271 N.Y.S. 1018 (1st Dept. 1934), <i>aff'd</i> , 266 N.Y. 577, 195 N.E. 208 (1935) -----	12
<i>Rich v. New York Stock Exchange</i> , 522 F.2d 153 (2d Cir. 1975) -----	14
<i>Russell v. Continental Illinois National Bank & Trust Co.</i> , 479 F.2d 131 (7th Cir. 1973) -----	4
<i>S.E.C. v. F.O. Baroff Co., Inc.</i> , 497 F.2d 280 (2d Cir. 1974) -----	8
<i>Securities Investor Protection Corp. v. Barbour</i> , 421 U.S. 412 (1975) -----	3, 8, 9
<i>Silver v. New York Stock Exchange</i> , 373 U.S. 341 (1963) -----	10

	<u>PAGE</u>
Cases:	
<i>Texas & Pacific Railway v. Rigsby</i> , 241 U.S. 33 (1916)	4
<i>Weinberger v. New York Stock Exchange</i> , 335 F. Supp. 139 (S.D.N.Y. 1971) and 403 F.Supp. 1020 (S.D.N.Y. 1975) -----	10, 11, 12
Statutes:	
N.Y. CPLR	
Section 203(c) -----	15
Section 214(2) -----	10, 12, 13
Securities Exchange Act of 1934	
Section 6, 15 U.S.C. § 78f -----	<i>passim</i>
Textbooks:	
Restatement of the Law, Second, Torts, Vol. 2, § 286 -----	4
1 Weinstein-Korn-Miller, <i>New York Civil Practice</i> ¶ 203.25 -----	15
Miscellaneous:	
H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970) --	8
H.R. Rep. No. 92-1519, 92nd Cong., 2d Sess. (1972) --	7
S.Rep. No. 94-75, 94th Cong., 1st Sess. (1975) -----	7, 8
Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92nd Cong., 2d Sess., <i>Securities Industry Study</i> , pt. 4 (1972) -----	7

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Preliminary Statement

Lank describes (Br.*5-8) certain disciplinary actions taken against Pickard as "leading" to the receivership proceeding. That characterization has no basis in the record except insofar as the actions recited preceded the

* "Br." refers to the designated page of Lank's brief.

receivership. The prior disciplinary history of Pickard is irrelevant to the issues on appeal. Its recitation can only be for the purpose of leading the Court to think that an injustice will be worked if the facts are not aired at a trial. Such a trial has been held. *Lansing v. New York Stock Exchange*, 68 Civ. 2872 (S.D.N.Y. 1973), *aff'd*, 490 F.2d 1406 (2d Cir.), *cert. denied*, 417 U.S. 912 (1974). There, in a timely action, a subordinated lender to Pickard challenged essentially the same transactions and Exchange actions questioned here by Lank. After trial, those claims were dismissed by Judge Bonsal and this Court affirmed. Lank's tactic of injecting irrelevant assertions may have influenced the decision below where the district court said:

"Having taken note of the regrettable behavior of Lank's attorneys, however, we also note that they have made substantial allegations of misfeasance by the Exchange which ought to be determined on the merits rather than because of attorney dalliance." (JA-221a)

However, by definition, every complaint within the jurisdiction of the federal courts that states a claim contains "substantial allegations." What might ultimately be shown on a trial is irrelevant. The question here is whether a trial should be had at all when the rules on standing and limitations are properly applied.

ARGUMENT

I

Lank Lacks Standing Because Pickard Lacks Standing.

Lank begins (Br. 11-12) his argument on standing by asserting that the issue has recently been resolved and that it is clear he has standing. The issue of standing under Section 6 has only recently received judicial consideration. With the exception of the Court of Appeals' brief refer-

ence in *Hughes v. Dempsey-Tegeler & Co.*, 534 F.2d 156, 166 n. 5 (9th Cir. 1976), all decisions on standing under Section 6 have been by lower courts. More importantly, no court has resolved the standing issue under Section 6 in light of the Supreme Court's recent decisions regarding when and for whom private causes of action may be implied and the importance of legislative history to such a determination.* *Ernst & Ernst v. Hochfelder*, 423 U.S. 816 (1976); *Cort v. Ash*, 422 U.S. 66 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975).

A. Lank's standing under Delaware law.

Lank appears to argue (Br. 12-16) that because a receiver under Delaware law is authorized to collect the assets of the corporation and to prosecute suits which the corporation might pursue, Lank has standing to pursue this action. The Exchange has no quarrel with the contention that a receiver may prosecute suits to collect the assets of a corporation. However, it is the Exchange's position that a member corporation lacks standing to assert a claim against the Exchange under Section 6; thus, such a claim is not an asset of the corporation and the action may not be pursued by the receiver. Indeed, Lank agrees with the Exchange, that under the general rule he has no greater standing than the corporation he represents:

"Thus, it is clear from Delaware law that the receiver has power to bring actions to recover assets for the estate which would accrue to the benefit of corporate creditors *where such a right exists in the corporation.*" (Br. 16) [Emphasis added.]

Lank's analysis of two cases relied on below to support his standing argument is misleading. *Keedy v. Sterling Electrical Appliance Co.*, 13 Del.Ch. 66, 115 A. 359 (1921)

* Lank's reference to "the shifting sands of legislative history" (Br. 19) is puzzling. There have been no "shifts" in the legislative history.

and *Bovay v. H. M. Byllesby & Co.*, 26 Del.Ch. 69, 22 A.2d 138 (1941), do hold that under Delaware law there are limited circumstances under which a receiver may assert a cause of action which the corporation would be barred from asserting. However, those circumstances are not present here. *Keedy* was an action to recover from the recipient property fraudulently conveyed. *Bovay* was an action against the perpetrators and beneficiaries of a fraudulent transfer of funds. But the Exchange is not alleged to be either a recipient of property fraudulently transferred or a perpetrator and beneficiary of a fraudulent transfer of funds. Lank does not seek to recover a fraudulent transfer, but admittedly seeks money damages for breach of duty. (Br. 4) The exception to the general rule cannot be stretched to support this suit. Since no right of action exists in the corporation, Lank has no such right.

B. Pickard lacks standing.

Prior to *Cort v. Ash*, *supra*, the test of whether a cause of action for breach of a statutory duty could be implied on behalf of a particular plaintiff depended on whether the plaintiff was a member of the class for whose protection the statute was enacted. *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Texas & Pacific Railway v. Rigsby*, 241 U.S. 33 (1916); *Russell v. Continental Illinois National Bank & Trust Co.*, 479 F.2d 131 (7th Cir. 1973); *Herpich v. Wallace*, 403 F.2d 792 (5th Cir. 1970); *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 at 208-9 (6th Cir. 1961); *General Time Corp. v. American Investors Fund, Inc.*, 283 F.Supp. 400 (S.D.N.Y. 1968); Restatement of the Law, Second, Torts, Vol. 2, § 286.

This rule was well stated in *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 at 789-790 (8th Cir. 1967):

"The Courts as a general rule recognize a private right of action for a violation of a statutory duty or a liability.

* * *

"However, a breach of statutory duty does not give rise to a private cause of action to every person injured by the statutory breach. The law clearly demands that the statutory breach must cause injury to one of the class that the statute is designed to protect. . . . We do not believe that the statute was designed for the protection of those who are not investors."

Lank does not even meet the requirements of that rule. However, the recent decision of the Supreme Court in *Cort v. Ash, supra*, has further narrowed the circumstances under which a private action may be implied for breach of a statutory duty. Now a plaintiff asserting such a claim must show that he is within the class for whose *especial* benefit the statute was enacted. The legislative history of the Exchange Act, and particularly of Section 6, compels the conclusion that the class entitled to protection under Section 6 is limited to public customers and that there is an antagonism between that class and the class of broker-dealers such as Pickard. (See the Exchange's Main Brief pp. 9-19 and 30-33) Thus, Lank fails the test of *Cort*.

Lank attempts to minimize the importance of *Cort v. Ash* by arguing that it sets forth "several theories" (Br. 20) for the implication of private actions. Lank misreads the case. There is only one theory in *Cort*, and all of the factors set out are relevant to a determination of when to imply a private cause of action. The two factors discussed by the Supreme Court which relate to whether the plaintiff before the court has standing to assert the action are:

"First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' *Texas & Pacific R. Co. v. Rigsby*, 241 U.S. 33, 39 (1916) (emphasis supplied)—that is, does the statute create a federal right in favor of the plaintiff?

* * *

"Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? See, e.g., *Amtrak, supra*; *Securities Investors Protection Corp. v. Barbour*, 421 U.S. 412, 423 (1975); *Calhoun v. Harvey*, 379 U.S. 134 (1964)." (422 U.S. at 78) [Emphasis added.]

Lank's discussion of *Cort v. Ash* avoids dealing with the crucial first factor. Lank's discussion of the second and fourth factors is irrelevant since the Exchange does not here dispute this Court's decision in *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944), that given the proper plaintiff (a public customer) a cause of action under Section 6 may be implied. The discussion in *Cort*, 422 U.S. at 80-82 and 84, emphasizes the importance of looking to the primary concern of Congress for a determination of the proper scope of the plaintiff class. *Baird v. Franklin* holds that public investors were the class for whose benefit Section 6 was enacted. Sustaining a cause of action by a member organization against the Exchange under Section 6 cannot be reconciled with that holding of *Baird v. Franklin* and the requirement of *Cort v. Ash*, as Section 6 cannot be for the especial benefit of both the member organization and the public customer.

Lank attempts to meet the third requirement in *Cort* by reference (Br. 21) to the "pervasive legislative scheme governing the relationship between the plaintiff class and the defendant class." (422 U.S. at 82) That reference, however, is inapposite. The regulatory scheme of the Exchange Act is aimed at governing the relationship between exchanges and their members, on the one hand, and the public customers of exchange members, on the other, for the protection of the latter. There is no indication in any section of the Exchange Act or its legislative history that shows that Congress intended to protect members of exchanges from exchanges.

Lank's assertions that (1) the Exchange's regulation failed to achieve the purposes of the Exchange Act and thus caused Pickard's loss (Br. 21), (2) that the "crisis" on Wall Street in 1970 is attributable to the failure of the Exchange to regulate its members (Br. 22), and (3) that the Securities Investor Protection Act was enacted to remedy Exchange failures (Br. 25), among other unsupported charges cast at the Exchange by Lank, state only one point of view in the debate* and, at best, are irrelevant. What is relevant is that the conclusions and recommendations made in H.R. Rep. No. 92-1519 (relied on at Br. 22, n.) and the Securities Investor Protection Act itself had as their object the protection of the public customer, not the brokers. Indeed, the object of the net capital rule, which Lank alleges the Exchange failed to enforce against Pickard, is to maintain the financial stability of Exchange members for the protection of their customers. As noted by the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92nd Cong., 2d Sess., Securities Industry Study, pt. 4, at 334 (1972):

"Violation of the [net capital] rule has always been regarded as meaning that there is an immediate threat to *customers* of the broker-dealer and to others with whom he deals which must be immediately rectified." [Explanation added.]

The class Congress sought to protect by Section 6 and which it continues to seek to protect in the Securities Investor Protection Act and in the Securities Reform Act of 1975 is the public investor, not the broker-dealer mem-

* See e.g., H.R. Rep. No. 92-1519, 92nd Cong., 2d Sess. at 1, 91 (1972); S.Rep. No. 94-75, 94th Cong., 1st Sess. at 22 (1975), where it was reported that: "[T]he securities industry's unique system of self-regulation has shown great strength in some areas and, in general, has served the industry well."

ber.* *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 at 421 (1975); *S.E.C. v. F. O. Baroff Co., Inc.*, 497 F.2d 280 at 283 (2d Cir. 1974); H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. at 1-2 (1970); S.Rep. No. 94-75, 94th Cong., 1st Sess. at 2 (1975).

Lank's citation of *J. I. Case Co. v. Borak*, *supra*, and *Blue Chip Stamps v. Manor Drug Stores*, *supra*, for his theory that developing case law under Section 6 requires that he be found to have standing adds little to his argument. Both cases support the position urged here by the Exchange. *J. I. Case* considered the availability of a private right of action under Section 14 of the Exchange Act. The Court referred to the legislative history of the Act (377 U.S. at 431), and noted the language of the section at issue proscribed certain conduct "'for the protection of investors.'" (377 U.S. at 432) In reliance on that expression, the Court implied a private cause of action on behalf of investors. This is practically the identical language used in Section 6 on which the Exchange bases its argument that protection of the investor is the object of Section 6, and the investor is the only proper plaintiff under Section 6.

Moreover, *Blue Chip Stamps* clearly limits the availability of the cause of action under Section 10(b) to the class intended to be protected. In reaching this conclusion, the Court considered the rule of *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 1356 (1952), and approved it, noting:

"Since both § 10(b) and Rule 10b-5 proscribed only fraud 'in connection with the purchase or sale' of securities, and since the history of § 10(b) revealed no congressional intention to extend a private civil remedy for money damages to other than defrauded

* It is, indeed, ironic that in the Securities Reform Act of 1975 Congress removed from Section 6 the requirement of an agreement with the Commission on which Lank must base his claim to avoid the three year statute of limitations.

purchasers or sellers of securities, in contrast to the express civil remedy provided by § 16(b) of the 1934 Act, the court concluded that the plaintiff class in a Rule 10b-5 action was limited to actual purchasers and sellers." (421 U.S. at 731)

This approach by the Supreme Court of implying a private right of action only to the class Congress intended to protect results in the conclusion that Lank lacks standing.

Lank's argument (Br. 24) that there has been a reasoned development of case law expanding Section 6 standing, commencing with *New York Stock Exchange, Inc. v. Sloan*, 394 F.Supp. 1303 (S.D.N.Y. 1975), rather than, as the Exchange asserts, a hesitance by district courts to disagree with a lengthy and scholarly opinion by a respected judge, is belied by the fact that virtually no consideration has been given to the application of *Ernst & Ernst v. Hochfelder, supra*, *Cort v. Ash, supra*, *Blue Chip Stamps v. Manor Drug Stores, supra*, or *Securities Investor Protection Corp. v. Barbour, supra*, to the determination of Section 6 standing.

Lank's off-hand treatment of the serious policy considerations inherent in imposing on exchanges duties to different classes with adverse interests distorts the issues. For example, Lank says (Br. 21):

"The Exchange laments, in conclusion, that to require it to fulfill the obligations it assumed under Section 6 subjects it to undeserved burdens and 'conflicting liabilities' (Appellant's Brief, pages 30-33)."

Lank misconstrues the Exchange's argument and misses the seriousness of the issue. The Exchange is willing to fulfill the obligations imposed by Section 6. The question here is what those obligations are. If those obligations run to its members, in the context here of an assertion that the Exchange failed to enforce compliance by its member with

its rules promulgated for protection of public investors,* the Exchange may very well take different steps from those it would take if its duty runs to public investors only. In the legislative history of the Exchange Act, Congress criticized the Exchange for resembling a private club. The position advocated by Lank is a step backward, for it attenuates the especial goal of the Exchange Act of protecting public investors.

II

The Receiver's Claim Under Section 6 is Barred by the Statute of Limitations of CPLR § 214(2).

Lank argues with respect to the second certified question, as he did with the first, that the issue is settled. (Br. 27-28) Again, the Exchange contends that the lower courts have followed one another, building on the first erroneous holding in *Weinberger v. New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971), and that the issue has never, until now, received needed appellate review.

Lank attempts to distinguish two causes of action under Section 6. (Br. 33) Lank characterizes his action as one based on "the Exchange's failure to perform . . . obligations . . . assumed." (Br. 2) He argues as if he had alleged a cause of action based on breach of contract. (*E.g.*, Br. 4, 11, 33) The Exchange concedes that the court below said it would permit Lank to replead a "contract" claim (JA-243a), and contends on this appeal that whether the allegations of the complaint assert a breach of statutory duty under Section 6(b) or a breach of contract under Section

* The Exchange concedes that by reason of its status it may, in other contexts, have duties to its members, and others, to enforce its rules fairly as among the members. *E.g.*, *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963); *Bright v. Philadelphia-Baltimore-Washington Stock Exchange*, 327 F.Supp. 495 (E.D. Pa. 1971). However, that is not the duty Lank seeks to impose here.

6(a) makes no difference either on the standing issue or the statute of limitations issue. However, Lank has never pleaded that the Exchange breached any agreement or assumed any obligations. The Exchange agrees with the court below (JA-234a) that there is no logic to applying different periods of limitations to identical claims because of the wording of the complaint. The Exchange also agrees with the courts in *Weinberger v. New York Stock Exchange*, 335 F.Supp. 139, 144 n. 10 (S.D.N.Y. 1971) and 403 F.Supp. 1020, 1028 n. 2 (S.D.N.Y. 1975); *Hughes v. Dempsey-Tegeler & Co.*, 534 F.2d 156, 166 n. 5 (9th Cir. 1976); and *Carr v. New York Stock Exchange*, 414 F.Supp. 1292, 1297 n. 1 (N.D. Cal. 1976) and with Lank (Br. 32) that there is little to be gained by implying different duties under Sections 6(a) and 6(b). However, if a distinction between the two is to be made as urged by Lank, as Section 6(a) was written any duty under that section can only involve enforcement of the Exchange Act and the S.E.C.'s rules and not enforcement of the rules of the Exchange. Not only is Lank's claim as pleaded based on breach of statutory duty (JA-12a) but it includes an alleged failure to enforce Exchange rules. (JA-8a, 9a) Therefore, if there are two separate causes of action, Lank has pleaded one under Section 6(b) only. If Lank wishes to prosecute an action for breach of Exchange rules, that action can only find a statutory basis in Section 6(b).

Lank contends that the Exchange's argument—that *Weinberger* was wrong in holding that the agreement under Section 6(a) with the Securities and Exchange Commission supports an action for breach of contract on a third party beneficiary theory—is an argument regarding standing. Perhaps such an argument could be made. However, here the Exchange is arguing (Main Brief pp. 40-42) that since an alleged breach of its agreement with the Commission could not support an action by one claiming to be a third party beneficiary, such an action cannot be termed a contract action for statute of limitations purposes. If the

action cannot be brought within the contract rubric, the contract limitations cannot be applied.

Lank's attack on the Exchange's argument that its agreement is distinguishable from those at issue in the cases relied on in *Weinberger* (since those existed independently of the statute while the Exchange's agreement did not) ignores the fact that the Exchange's "agreement" is nothing more than a recital of the statutory language. *Weinberger v. New York Stock Exchange*, 403 F.Supp. 1020 at 1026 (S.D.N.Y. 1975) The Exchange's agreement imposes no obligations not imposed by the statute in the absence of the agreement, and, thus, cannot stand as a separate contract. No doubt that is why the requirement of the agreement did not survive the Securities Reform Act of 1975.

In any event, the Exchange and Lank appear to be in accord on the test for application of the three year provision of CPLR § 214(2). Lank says it is:

"A liability created by statute is one which 'did not exist at common law' and which 'would not exist but for the statute.' *Frank Shepard Co. v. Zachary P. Taylor Publishing Co.*, 234 N.Y. 465, 468, 138 N.E. 409 (1923)." (Br. 33)

Since no cause of action against an exchange for failure to enforce the Exchange Act, rules thereunder or its own rules would exist in the absence of Section 6,* any claim

* *New York Stock Exchange, Inc. v. Goodbody & Co.*, 42 A.D.2d 556, 345 N.Y.S.2d 58 (1st Dept. 1973); *Raldiris v. Simmons*, 242 App. Div. 603, 271 N.Y.S. 1018 (1st Dept. 1934), *aff'd*, 266 N.Y. 577, 195 N.E. 208 (1935) (decision of trial court reproduced in addendum to Main Brief at p. A-52); *Morganbesser v. New York Stock Exchange*, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,210 (Sup. Ct. Nassau Co. 1971); *New York Stock Exchange, Inc. v. Pickard & Co.*, 282 A.2d 651 (Del. Ch. 1971); *Krasnow v. Kern Securities Corp.*, 175 N.Y.L.J., May 17, 1976, p. 8, col. 6 (Sup. Ct. N.Y. Co.).

under Section 6 meets the test for application of CPLR § 214(2). Moreover, if Lank's claim were a simple common law breach of contract action, he could have asserted it as a counterclaim in the receivership proceeding in Delaware. Yet, the Delaware court found that it lacked jurisdiction because of the exclusive jurisdictional provision contained in Section 27 of the Exchange Act.

Lank argues (Br. 34) that the only liability that could arise under Section 6(a) would be for failure to file the agreement. Following this argument, no liability could arise under Section 6(b) or (d) except for failure to have the specified rules. That proposition was rejected by this Court in *Baird v. Franklin*, *supra*.

Lank argues (Br. 35-39) that policy considerations favor the longer period of limitations despite whatever irrationality results* to avoid "prematurely" cutting off remedies (Br. 36) and quotes the opinion below to the effect that discovery of an exchange's failure to enforce its rules may entail some lapse of time. Of course, some lapse must occur for the failure to enforce rules to result in any damage, a prerequisite to suit. However, the cause of action is not complete, and the statute does not begin to run, until damage has accrued. *Baird v. Franklin*, *supra*. Three years is hardly a short limitations period, and if damage is proximately caused by an exchange's failure to enforce, it is highly unlikely that the failure would not be challenged well within that period, as it was in respect to the Exchange's regulation of Pickard. See *Lansing v. New York Stock Exchange*, *supra*, p. 2.

* The irrationality of applying a contract period of limitation to Lank's claim here will be further compounded in the future as Section 6 no longer contains a requirement of an agreement. See Section 6 as revised by the Securities Reform Act of 1975 reproduced in the addendum to the Exchange's Main Brief at pp. A-2 through A-8.

Lank asserts (Br. 37) that application of a six year period does not offend the state policy behind statutes of limitations of barring claims where proof would be difficult. Lank goes on to make a most telling argument for the Exchange. He notes the difference in length of periods of limitations for tort and for contract and says the reason for the difference is the difference in the character of evidence. (Br. 38) First, it is readily apparent that an action under Section 6, whether 6(a) or 6(b), if there is a distinction, is most similar to a negligence claim. In *Rich v. New York Stock Exchange*, 522 F.2d 153 at 155 n.4 (2d Cir. 1975), this Court noted:

“And subsequent decisions, while being careful not to hold the Exchange to a duty of supervision that is unrealistic have upheld claims on what is essentially a negligence standard.”

See also *Marbury Management Inc. v. Kohn, Wood, Walker & Co.*, 373 F.Supp. 140 at 142-43 (S.D.N.Y. 1974); *Fischer v. New York Stock Exchange*, 408 F.Supp. 745 at 757 (S.D. N.Y. 1976). Second, the evidence of a claim under Section 6(a) is not like evidence in a contract case. The evidence will not be the written “contract” filed by the Exchange with the Commission and related documents, as it would be in a contract case. It will consist in substantial part of the oral testimony of witnesses who participated in the challenged acts or omissions to determine whether the Exchange’s standard of conduct was adequate on what it reasonably knew and the alternatives available to it. See e.g., *Hughes v. Dempsey-Tegeler & Co.*, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,133 (C.D. Cal. 1973), *aff’d*, 534 F.2d 156 (9th Cir. 1976).

III

Dismissal of the Complaint is Appropriate.

In his Point III Lank attempts to raise new issues of tolling and recoupment to avoid dismissal of his complaint. These issues are not pleaded in the complaint, were not considered by the court below, were not certified for this appeal and should not be considered here. *First National Bank of Cincinnati v. Pepper*, 454 F.2d 626 at 636 (2d Cir. 1972) In any event, the questions raised in Lank's Point III have no bearing on the first certified issue and thus, even if properly raised, do not preclude dismissal of the complaint.

Furthermore, Lank's argument that the statute of limitations should be tolled because there was no one to assert Pickard's claim is groundless. Either Pickard or, upon his appointment in May 1968, its liquidator could have brought this action before the expiration of the statute of limitations. (JA-61a, 77a) There is no basis for Lank's cryptic assertion of a conflict. (Br. 40) Lank's contention that he is entitled to a set-off under the doctrine of equitable recoupment (Br. 40) is equally meritless. That doctrine has its origin in N.Y. CPLR § 203(c) which by its terms is limited to defenses and counterclaims. Even if it were applicable to the affirmative assertion of a claim, it is inapplicable here as the claim must arise out of the same transaction or series of transactions as the claim against which it is to be set off. N.Y. CPLR § 203(c); 1 Weinstein-Korn-Miller, *New York Civil Practice* ¶ 203.25. Lank's claim does not arise out of the agreements, which are the subject of the Exchange's first and second counterclaims, between Pickard and the Exchange and the Exchange's Special Trust Fund by which Pickard secured the assistance of the Exchange and the Special Trust Fund to put its books and records in order and to protect its customers against loss.

CONCLUSION

The order of the court below denying the Exchange's motion to dismiss should be reversed, and the case remanded with a direction that the complaint be dismissed.

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New York, N.Y.

Respectfully submitted,

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